No. 10556

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED NATIONAL CORPORATION, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REVIEW FROM THE TAX COURT OF THE UNITED STATES

BRIEF OF *AMICUS CURIAE*

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QUESTION PRESENTED

This is a petition for review, pursuant to Sections 1141 and 1142 of the Internal Revenue Code, of a decision of The Tax Court of the United States herein entered June 15, 1943 (R. 43-47).

There is no controversy between the parties as to the facts; the only question presented to this Court is a question of law, to wit: When a corporation repurchases shares of its own stock for less than their par value and retires the shares, does the amount by which the par value exceeds the repurchase price constitute earnings or profits to the corporation?

The petitioner owned all the common stock of Murphey, Favre & Co., a corporation. Murphey, Favre & Co. in 1929 to 1932 repurchased its outstanding preferred stock at $20,389 less than the par value thereof, and the shares were retired or cancelled. In 1938, the petitioner surrendered for cancellation 75% of the common stock of Murphey, Favre & Co. and received therefor 75% of the assets of that company. The other 25% of the common stock was later sold.

The Tax Court of the United States held that, pursuant to Section 115(a) and (g) of the Revenue Act of 1938, the $20,389 by which the par value of the retired preferred stock exceeded the repurchase price of those shares constituted earnings or profits of the corporation, and increased accordingly the portion of the amount distributed by Murphey, Favre & Co. to the petitioner which was to be taxed to the petitioner as a dividend rather than as a distribution of capital.

SUMMARY OF ARGUMENT

It is the contention of *amicus curiae* that said $20,389 constituted capital surplus rather than earnings or profits of Murphey, Favre & Co., and that therefore any distribution thereof constituted a distribution of capital and not a dividend.

ASSIGNMENTS OF ERROR

The petitioner assigns as error the following acts and omissions of The Tax Court of the United States:

1. The determination by The Tax Court of the United States that the sum of $20,389, representing the discount on the redemption of the preferred stock of Murphey,

Favre & Co., was a part of the accumulated earnings or profits of Murphey, Favre & Co. and that petitioner received taxable income in any amount greater than $88,120.80 upon the partial liquidation of Murphey, Favre & Co. on the redemption of 750 shares of stock of Murphey, Favre & Co. held by petitioner.

ARGUMENT

Where a corporation repurchases shares of its own stock for less than their par value and retires the shares, the amount by which the par value exceeds the repurchase price is not a part of its earnings or profits.

The decision of The Tax Court below holding otherwise (1) is in direct conflict with the express provisions of the applicable statute and all other court decisions interpreting them, (2) runs counter to the long established practice of the Treasury Department in administering the statute, (3) is inconsistent with the legislative policy which Congress evidenced in the Second Revenue Act of 1940 (applicable retroactively to prior Acts), and (4) is directly opposed to well established principles of sound accounting.

Introduction

As forcefully brought out by Paul in his *Studies in Federal Taxation,* (Second Series, p. 149) it is important to recognize at the outset that Congress has not seen fit to tax as a dividend every distribution by a corporation from every source whatever. Since 1916, Congress has limited "its broad constitutional right to tax by establishing a new statutory test of taxability of corporate distributions to stockholders,—the test of the *source in the corporation of the distribution,* more particularly, the test of whether the

distribution was out of 'earnings or profits'" (Paul, pp. 150-151). Thus a distribution of a capital surplus resulting from capital rather than revenue transactions, is not a dividend within the meaning of the tax law; such a distribution is governed by the provisions of Section 115(d) of the Revenue Acts of 1938 and other Revenue Acts rather than Section 115(a) or (g), and is applied against and reduces the stockholder's cost basis for his stock. Where a shareholder surrenders his interest in a corporation and leaves part of the capital which he originally contributed, the corporation has a surplus of capital but not earnings or profits; the amount is properly accounted for as capital surplus and not earned surplus.

(1) The purchase and retirement of shares of its own stock did not give rise either to income or to earnings or profits to Murphey, Favre & Co.

Under § 115(a) of the Revenue Act of 1938 (and the corresponding provision of prior Revenue Acts back to the Act of 1916) a dividend has been defined as a distribution by a corporation out of its "earnings or profits". The expression "earnings or profits" corresponds to the accounting concept of earned surplus, as opposed to capital and capital surplus. For over twenty-five years since it first appeared in the Revenue Act of 1916, apart from the decision below in the present proceeding, the expression has consistently been interpreted to mean the excess of the income receipts (as distinguished from the capital receipts) of a corporation over its income deductions (as distinguished from its capital expenditures).

The present case is concerned only with the first half of the formula, *i.e.* with the *receipts* which enter into the

computation of "earnings or profits". It is important to observe this fact. For admittedly taxable *net* income is not the same as "earnings or profits" because of certain express statutory exclusions from gross income and limitations on deductions of expenditures (contained principally in § 22(b) and § 23 of the Revenue Acts) which enter into the computation of taxable net income and do not enter into the computation of "earnings or profits". But that is irrelevant. The significant point is that all receipts which are included in the computation of "earnings or profits" are also included in *gross* income as defined in § 22(a) of the Revenue Acts.

For "gross income" is defined in § 22(a) of the Revenue Act of 1938 (and *haec verba* in prior Revenue Acts back at least to the Revenue Act of 1928—which includes all Revenue Acts here involved) as follows:

> "(a) General Definition.—'Gross income' includes gains, *profits,* and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or *profit,* or gains or *profits* and income derived from any source whatever. * * *" (Italics added)

"Profits" are expressly included. And it is submitted that the term "earnings" does not encompass more than the sweepingly broad balance of the definition of gross income which remains when we exclude the term "profits". The Supreme Court has said that in § 22(a) Congress intended

to use its powers of income taxation to their full measure. *Helvering* v. *Stuart,* 317 U. S. 154, at 169, 63 S. Ct. 140, and cases there cited. In short the general statutory concept of "gross income" as defined in § 22(a) obviously includes all receipts entering into the computation of earnings or profits.

The Tax Court in the present proceeding said:

> "The Murphey Co. realized a gain upon the redemption of all of its preferred stock. Of course that gain was not a taxable gain. But we think it must be considered as constituting part of the 'earnings or profits' accumulated after February 28, 1913."

But if there was a gain to the corporation, as distinguished from a capital transaction involving a mere reshuffling of the proprietary interests in the corporation, it obviously would have resulted in a taxable gain. § 22(a) includes in taxable gross income "gains derived from any source whatever" except as specifically excluded elsewhere in § 22, and there is no such exclusion here. It being obvious that the corporation had no taxable gross income from the transactions in question because it had no "gains or profits [or] income derived from any source whatever", it is equally clear that a corporation which has no "gains, profits [or] income from any source whatever" in respect of given transactions has no earnings or profits from those transactions. A decision that there is no taxable "gross income" within the meaning of § 22(a), is necessarily a decision that there are no earnings or profits within the meaning of § 115(a).

It has never been held that a corporation realized income from the mere retirement of its own shares. This has

universally been regarded as a capital transaction and not a revenue transaction. As has just been pointed out, even the Tax Court in the decision involved in this appeal considered that point obvious.

Similarly, where subscribers to capital stock, after making partial payment on their subscriptions, have defaulted and the stock subscribed for together with the payments already made has been declared forfeited, the distinction between capital receipts and income has been carefully preserved and the courts have consistently held that the defaulted payments do not constitute income to the corporation even though the persons making the payments have ceased to have any interest in the corporation. For example, the Board of Tax Appeals, as long ago as 1926, in *Illinois Rural Credit Assn.*, 3 BTA 1178 (Acq.), held that:

> "The payments on account of the stock subscriptions, at the time they were made, were undoubtedly capital payments, being made to provide capital for the corporation, and were in its hands capital receipts as distinguished from income. The fact that payments were made in instalments and stock was never issued for such payments, because they were not made to the full amount of the subscriptions, does not alter their character."

See also, *Industrial Loan & Investment Co.*, 17 BTA 1328 (Acq.); *Inland Finance Co.*, 23 BTA 199, affd. by C. C. A. 9 at 63 F. (2d) 886; *Realty Bond & Mtg. Co.* v. *U. S.* (Ct. Cls.), 16 F. Supp. 771; and *Terminal Grain Corp.* v. *U. S.* (D. C. Iowa), 1938 CCH Fed. Tax Serv., par. 9181, 22 A. F. T. R. 1290.

Going further, it has now been authoritatively settled by the Supreme Court that even though a corporation sub-

sequently resells shares of its own stock which it has purchased, rather than retires or cancels them, the transaction still retains its character as a capital transaction not giving rise to income under § 22(a) of the Revenue Acts, at least in the case of transactions in 1933 and prior years (which are the years in which the transactions involved in the present proceeding occurred). *Helvering* v. *Reynolds Tobacco Co.,* 306 U. S. 110, 59 S. Ct. 423; *First Chrold Corp.* v. *Commissioner,* 306 U. S. 117, 59 S. Ct. 427. The Supreme Court decision rested upon the Commissioner's regulation in force during this period providing that (Reg. 74, Art. 66):

> "If . . . the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered *a capital transaction* and *the proceeds of such sale will be treated as capital* and will not constitute income of the corporation. *A corporation realizes no gain or loss from the purchase or sale of its own stock.*" (Italics added.)

Since the reacquisition and retirement of shares of its own stock by Murphey, Favre & Co. during the years 1929 to 1932 here involved did not give rise to any gross income as defined in § 22(a), it follows irrefutably that they did not give rise to earnings or profits (which encompass nothing not included in gross income as defined in § 22(a) of the applicable Revenue Acts). Since such transactions were capital transactions and the proceeds thereof capital and not income of the corporation, by the same token they did not constitute earnings or profits, for capital is just as surely the antithesis of earnings and profits as it is of income.

(2) The position of the Commissioner in this case runs counter to the long established practice of the Treasury Department.

The principle that the repurchase by a corporation of its own shares at a price below the amount originally paid in for them does not give rise to earnings or profits any more than income was expressly recognized by the Commissioner as long ago as 1923, in *IT 1802,* II-2 CB 267 (1923), wherein it was said:

> "Accordingly, when the corporation purchased its own stock at a price below the paid in value of the shares it acquired, the amount paid out by the corporation represented a return of paid in capital, *and the difference between the amount paid by the corporation and the paid in value of the shares represented paid in surplus, and earned surplus was not affected by the transaction."* (Italics added.)

This ruling is one of the thirty-one Treasury rulings and regulations, and decisions of the Board of Tax Appeals, cited by the Supreme Court in the *Reynolds* case, *supra,* at page 8, establishing that a transaction by a corporation in its own shares had been uniformly regarded as a capital transaction with respect to each of the Revenue Acts from that of 1913 through that of 1932.

(3) The decision of the Tax Court below is inconsistent with the legislative policy which Congress evidenced in the Second Revenue Act of 1940.

In the Second Revenue Act of 1940 Congress enacted the war-time excess profits tax, many of the provisions of which depend upon the earnings or profits of the corpora-

tion subject to the tax. In the same Act, and in view of the added importance which the concept of earnings or profits accordingly assumed, Congress clarified in certain respects the scope of the expression by the addition of §§ 115(l) and (m) to the Internal Revenue Code and *to all prior Revenue Acts.* These provisions thus reflect certain fundamental legislative policies with regard to the application of the concept of "earnings or profits".

The additional provisions are significant here because in them Congress evidenced an intention (a) that in general the receipts entering into the computation of earnings or profits conform with those entering into the computation of taxable gross income except where explicit statutory provisions require otherwise (House Com. Rep. on § 401 of the Second Revenue Bill of 1940); and, (b) that, as in the computation of net income, earnings or profits be computed in accordance with the law applicable to the year in which the relevant transactions giving rise thereto took place (§ 115(l), in at least three places, stressing that computations are to be made under the law applicable to the year in which the transaction giving rise to the earnings took place).

The decision of the Tax Court below runs directly counter to the legislative policy here enunciated; although there is nothing in the concept of earnings or profits that requires such a result, it goes out of its way to make the receipts entering into the computation of earnings or profits something different from those entering into the computation of gross income. And it ignores the decisions of the Supreme Court in the *Reynolds* and *Chrold* cases, *supra,* at page 8, which have established with finality the principles of law applicable to the tax years in which took place the redemptions of stock here involved.

(4) It is contrary to well established principles of accounting to hold that the mere purchase and retirement of a corporation's own shares gives rise either to income or to earnings or profits to it.

The House Ways and Means Committee, in its report on Section 401 of the Second Revenue Act of 1940, took occasion to stress the importance in this connection of following sound accounting practice, pointing out that:

> "While prescribing rules for certain cases * * * section 401 contemplates that consistently with these rules the computation shall be made conformably to the best accounting practice."

Tested by accepted accounting principles, it is clear that the mere purchase and retirement of a corporation's own shares does not result in earnings or profits to the corporation.

On this point the Securities and Exchange Commission has ruled as follows:

> "It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus." (SEC Accounting Series Release No. 6)

Likewise, the Committee on Accounting Procedure of the American Institute of Accountants, in its Accounting Research Bulletin of September 1939, has said:

> "Apparently there is general agreement that the difference between the purchase price and the stated

value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses * * *." (This rule also appears in the Journal of Accountancy, Vol. LXV, pp. 417-418. To the same effect, see also *Kester, Accounting Theory and Practice,* 369; *Montgomery, Auditing Theory and Practice,* 402; *Sunley & Pinkerton, Corporation Accounting,* 121; *Streightoff, Advanced Accounting,* 19.)

The Circuit Court of Appeals for the Third Circuit aptly described the situation in the *Chrold Corporation* case, subsequently affirmed by the Supreme Court, *supra,* at page 8, when it said:

> "A corporation which purchased shares of its own stock for less than the sum for which it was issued and then retires the stock may have been advantaged by the transaction in a sense but the real gain is by its remaining stockholders and not by the corporation as such. The change effected is merely a change in the corporate structure. The Treasury regulations so stated and the Courts have so ruled." (97 F. (2d) 22.)

The stockholders of a corporation are its proprietors. It exists to make earnings or profits for them. It cannot profit at their expense. Whenever a corporation issues additional shares or retires shares, the relative proprietary interests of the remaining stockholders are altered; but the corporation does not profit any more than it would if one stockholder were to buy out the shares of another stock-

holder or if the rights of the shareholders *inter se* were otherwise altered. Such transactions have always been regarded as capital transactions or transactions affecting the proprietary shares in the enterprise, as opposed to revenue transactions.

Admittedly the mere fact that shares of its stock are involved in a transaction does not preclude the realization of a profit by a corporation. For example, a corporation may have a gain when it utilizes assets which have appreciated in value to repurchase shares of its own stock; but in such a case the profit is in respect of the assets so utilized and not in respect of the retirement of its stock. For all authorities are agreed that the mere retirement by a corporation of shares of its own stock for cash does not give rise to income or to earnings or profits to it. *Rankin, Income Tax Aspects of a Corporation's Dealings in its Own Shares,* 89 U. of Pa. L. Rev. 934, and numerous authorities there collected.

CONCLUSION

It is submitted that The Tax Court of the United States was in error in holding that the earnings or profits of Murphey, Favre & Co. were increased by that corporation's repurchase, for less than their par value, and retirement of shares of its own stock.

Respectfully submitted,

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